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MICHAEL RODAK, JR., CLERK

IN THE
Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

**PETITIONER'S REPLY TO BRIEF OF RESPONDENT IN
OPPOSITION TO PETITION FOR CERTIORARI**

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INVENTORY ISSUE

I.

Respondent's brief wholly ignores that there are 371 cases docketed in the Tax Court and an unknown number pending in Federal District Courts involving the valuation of excess inventory. There are an additional 493 cases pending in the Appellate Division and an estimated several times that number in the Audit Division of the Internal Revenue Service, a substantial number of which inevitably will find their way into the courts. See *amicus* brief of the National Association of Manufacturers ("NAM") 4. This case thus presents an unusual opportunity for this Court to resolve the excess inventory valua-

tion issue by a definitive decision, thereby avoiding years of wasteful litigation and relieving the Federal courts of most of the pending cases.

A review by this Court would be particularly effective in reducing litigation in this instance because both the Commissioner and the Tax Court are interpreting the decision of the Seventh Circuit as an absolute prohibition against the writedown of excess inventory prior to its scrapping. See Rev. Rul. 77-364, I. R. B. 1977-41, p. 9 (discussed in the NAM brief 8), and *Altec Corporation*, 36 T.C.M. 1795 (CCH) (Tax Court Memorandum Decision 1977-438, December 29, 1977).

This case involves more than a technical tax issue with an extraordinarily large amount of potential tax liability to thousands of businesses. As the thoughtful *amicus* briefs filed in this case by the NAM and the Chamber of Commerce of the United States ("Chamber") abundantly show, the decision of the Seventh Circuit flies in the face of deeply rooted concepts of the business and accounting communities as to what constitutes taxable income. To require unsalable inventory to be valued far above its actual realizable value, and thereby increase taxable income by such overvaluation, strikes the businessman as profoundly unrealistic and unfair.¹

II.

Respondent's brief fails to come to grips with the central question involved in this case—does the action of the Commissioner in refusing to allow excess inventory to be written down to net realizable value conform to the dual statutory mandate of section 471 that a taxpayer's inventory method must (i) constitute the best accounting practice in the taxpayer's trade or business and (ii) clearly reflect income. Neither the Seventh Circuit nor Respondent questions the Tax Court's findings that

1. The S. E. C. would view it as illegal to overstate income in such a way.

Thor's inventory valuation procedures constituted the best accounting practice and that these procedures, required by generally accepted accounting principles, clearly reflected Thor's income for *financial accounting purposes*.

Notwithstanding these facts, Respondent argues, parallel to the opinion of the Seventh Circuit, that Thor has not proven that its income was clearly reflected for *income tax purposes*. The only authoritative source available to Thor for establishing this are the Regulations and generally accepted accounting principles.

It is conceded by both sides that the Regulations do not explicitly cover the valuation of excess stock. Although provisions of the Regulations defining market value, § 1.471-4(b), and permitting the writedown of subnormal goods, § 1.471-2(c), could be construed to authorize Thor's valuation procedures (see Petition 21-24 and Chamber brief 14-17), Respondent argues that the Seventh Circuit was correct in narrowly and literally construing them not to do so. Respondent's position seems to be founded on the premise that unless the Regulations explicitly permit a taxpayer to write down excess inventory to net realizable value, he is prohibited from doing so (*e.g.*, Resp. brief 5, 7). Respondent even suggests that these Regulations are "legislative in character" (*id.*, 5, n. 3). While it is highly questionable whether the inventory Regulations fall within the purview of legislative regulations, it is inconceivable that the failure of regulations to deal explicitly with an issue could be deemed legislative.²

Thor's attempt to show that it clearly reflected its income based on the authority of generally accepted accounting principles is rejected by Respondent for the reason that "[i]t is well settled that tax accounting principles differ from generally accepted accounting principles, and that compliance with gen-

2. Respondent does not seem troubled by the Treasury's long-continued failure to amend the Regulations to cover the valuation of excess inventory, notwithstanding its knowledge that they were inadequate. See Petition 23 and Chamber brief 6-7.

erally accepted accounting principles does not establish that a taxpayer's method of accounting clearly reflects its income for income tax purposes" (Resp. brief 6), citing this Court's prepaid service income decisions in *American Automobile Association v. United States*, 367 U. S. 687 (1961), and *Schlude v. Comm'r*, 372 U. S. 128 (1963). This approach erroneously upgrades a narrow exception to the status of the general rule. Both cases involved the limited issue of whether prepaid service income of an accrual basis taxpayer was taxable in the year received or could be amortized over the years the services were to be rendered. In two 5-4 decisions, this Court held that prepaid income was taxable when received, primarily because a unique legislative history showed that to be the intent of Congress. 367 U. S. at 694-98; 372 U. S. at 134-35. Nothing in either majority opinion suggests in the slightest that this Court was adopting a general policy that tax accounting was no longer to follow generally accepted accounting principles as its progenitive authority. To the contrary, some 15 years after those decisions, they remain the only significant non-statutory exception to the rule that tax accounting follows generally accepted accounting principles. See generally 367 U. S. at 698-703 and 372 U. S. at 137 (dissents by Stewart, J.).

Moreover, there is no reference in either decision to inventory valuation or section 471. Indeed, if the express language of section 471—requiring inventory to be valued according to the best accounting practice—is to be followed, the prepaid income cases cannot govern the valuation of inventory.

Respondent's brief also disputes the inherent conflict in principle between the decision of the Seventh Circuit in the instant case and those of the Fifth and Sixth Circuits in *Space Controls Inc. v. Comm'r*, 322 F. 2d 144 (5th Cir. 1963), and *E. W. Bliss Co. v. United States*, 351 F. 2d 449 (6th Cir. 1965), *affirming on the opinion below*, 224 F. Supp. 374 (N. D. Ohio 1963). In those cases, the Courts of Appeals complied with the statutory mandate of section 471 and construed the Regulations to con-

form to generally accepted accounting principles. See 322 F. 2d at 148-49, 154-55; 224 F. Supp. at 379-82. As a consequence each court permitted the taxpayer to write down inventory to net realizable value, notwithstanding the Commissioner's arguments, *identical to those made in this case*, that the Regulations required valuation at replacement cost and that no writedown could take place without a "realization"—*e.g.*, by delivery to the customer (scrapping in the instant case). The decision below conflicts with these decisions because the Seventh Circuit concluded that generally accepted accounting principles were irrelevant in determining whether or not Thor's writedown of excess inventory to net realizable value clearly reflected its income.

Perhaps the most vexing aspect of Respondent's brief is that it ignores the common sense of the issue before this Court. Notwithstanding that the Regulations do not adequately provide for the valuation of excess inventory, of which the Treasury has been aware for years, Respondent in effect argues that such silence constitutes a *de facto* prohibition against writing down such inventory to net realizable value. The realistic alternative of construing the Regulations by reference to the more advanced and comprehensive concepts of generally accepted accounting principles is rejected solely on the basis of the *non sequitur* that tax accounting does not follow generally accepted accounting principles in the limited area of prepaid service income. Like the opinions of both courts below, Respondent's brief does not explain how Thor's valuation procedures failed to clearly state its income. Thus, under Respondent's approach Thor is unable to prove that its valuation procedures clearly reflect income by reference either to the Regulations or to generally accepted accounting principles. Thor consequently is deprived of the benefit of the specific language of section 471³ and § 1.471-2(b)

3. The limited legislative history of section 471 supports its clear language. See Chamber brief 8 and NAM brief 9.

of the Regulations thereunder, which create the presumption⁴ that inventory values determined in accordance with the best accounting practice clearly reflects taxable income. The result is that Thor's inventory for 1964 is overvalued by some \$927,000, thereby overstating its taxable income for that year by the same amount. This overstatement continues indefinitely until the excess inventory is scrapped in later years.

BAD DEBT ISSUE

Although Respondent repeatedly refers to the incomplete and ambiguous Regulations as authority in discussing the inventory issue, Respondent fails to mention that the automatic imposition of the *Black Motor* formula is directly contrary to the language of § 1.166-4(b)(1) of the Regulations, which require that taxpayers' reserve for bad debts "... shall be determined in light of the facts existing at the close of the taxable year ...".

Respondent couples this omission with the remarkable assertion that the decision of the Seventh Circuit does not conflict with *Calavo Inc. v. Comm'r*, 304 F. 2d 650 (9th Cir. 1962); *Rhode Island Hospital Trust Co. v. Comm'r*, 29 F. 2d 339 (1st Cir. 1928); or *Travis v. Comm'r*, 406 F. 2d 987 (6th Cir. 1969), because in those cases the "taxpayers were able to demonstrate on the evidence that the Commissioner's recomputation of their bad debt reserve was an abuse of discretion" (Resp. brief 10), which Respondent erroneously contends Thor failed to do in the instant case. To the contrary, in each of those decisions, the Commissioner was found to have abused his discretion because he refused to consider current data as to the collectibility of the taxpayers' accounts receivable. In contrast with those decisions, the Seventh Circuit extends to the Com-

4. Respondent (brief 6 n. 4) refers to the Seventh Circuit's statement that the presumption was rebutted by Thor's alleged lack of consistency in computing its opening and closing inventories for 1964. As already explained in the Petition (p. 25 n. 7) the point is without merit because by pretrial order the Tax Court excluded any evidence on this point.

missioner a *carte blanche* right to impose the *Black Motor* historical formula regardless of the reasonableness of the taxpayer's current data on the collectibility of its accounts. To Thor's knowledge, no other court has gone that far.

CONCLUSION

Respondent's brief continues the Seventh Circuit's inconsistent position between the inventory and bad debt issues. As discussed more fully in the Petition (p. 12), Respondent objects to Thor's use of a formula to identify and value excess quantities of some 44,000 different items of inventory that it could not feasibly individually value, while Respondent simultaneously insists that Thor use an historical formula to value its accounts receivable that it had individually valued.

* * *

For these reasons and those stated in the Petition, Petitioner respectfully requests that the Writ of Certiorari be granted.

Respectfully submitted,

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